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POSTAL RATE AND FEE CHANGES, 1997

Docket No. R97-1

REPLY BRIEF  
OF THE  
SATURATION MAIL COALITION

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The Saturation Mail Coalition hereby submits this Reply Brief to the Commission in this proceeding.

**OVERVIEW AND SUMMARY**

**A. NAA's Over-The-Top Rate And Rate Structure Proposals For ECR Mail.**

Our reply brief focuses primarily on the rate proposals and arguments of the Newspaper Association of America. Its proposals are audacious and threaten not only saturation mail and mailers, but the continued viability of beneficial competition in the advertising distribution marketplace, the health and viability of the postal system as it faces increasing competitive inroads into its core markets, and the long term interests of all mailers and the public.

NAA's pricing proposals to shift additional institutional costs onto ECR and particularly saturation mail, the most competitive and price sensitive segment of the mailstream, would toss sound principles of economically-efficient, market-based pricing out the window, solely for the benefit of competitors who would thereby be freed of the market disciplines of competition.

Indeed, NAA's phony "weighted attributable cost" pricing scheme is too much for its newspaper brethren at the National Newspaper Association (NNA). Unlike NAA's membership that is dominated by large metropolitan daily newspapers and large chains that don't use the mail to deliver their newspapers, NNA's membership consists primarily of smaller and more rural daily and weekly newspapers that actually use the mail to deliver their newspapers. Tr. 14743-45 (Heath). Moreover, NNA's members

make substantial use of ECR mail to distribute nonsubscriber products, most of which are saturation walk-sequenced, DDU-drop shipped flats that weigh over the breakpoint -- the precise kind of mail targeted by NAA for steep rate increases.<sup>1</sup>

NAA's pricing and rate structure proposals would likewise eviscerate reclassification. Every one of its pricing, rate design, and rate structure proposals has the singular objective of raising the rates for saturation mail to non-competitive levels without regard to costs, rationality, or sound ratemaking principles. Having failed to block the needed reclassification of carrier route mail as a separate Enhanced Carrier Route subclass, NAA now attempts to "declassify" ECR mail indirectly through a number of transparent schemes. It urges that the ECR rates and rate structure be "locked into" the Regular subclass rates through rigid "crossover-point" relationships, in essence re-transforming the ECR subclass into a rate category of the Regular subclass, just like the "good old days" before reclassification. It urges a carefully concocted scheme of modifying the Postal Service's ECR rate structure with higher pound rates, higher letter/flat rate differentials, and reduced density-related presort rate differentials that bear no resemblance to true cost behavior and ignore clear cost and rate relationships between these various rate structure elements. The only consistency is the end result -- higher rates for ECR saturation flat mail, the very component of the ECR subclass that the Commission recognized best satisfied the cost and demand criteria of the Act and most justified the creation of ECR as a separate subclass.

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<sup>1</sup> A survey presented by NNA witness Heath suggests that its members may actually make greater use of Standard A mail than Periodicals mail. The survey showed total second-class volumes of 2.558 million, compared to total third-class volumes of 2.576 million (consisting of 2.524 million nonsubscriber products and .053 million newspapers mailed at third class). Tr. 14778 (newspaper volumes) and 14781-82 (nonsubscriber product volumes). Over 90% of the third-class nonsubscriber product volumes in the survey were mailed at ECR rates. Tr. 14781-82. Of those ECR volumes, 70% were saturation walk-sequenced and DDU drop shipped, and 60% weighed above the breakpoint. *Id.* Given that ECR rates are substantially higher than In-County rates, it could well be that the total ECR postage paid by NNA members substantially exceeds their Periodicals postage -- placing many NNA members directly in the "blast zone" of NAA's attack on ECR mail.

**B. Other Issues.**

Volume Variability and Distribution of Mail Processing Costs. Although the Saturation Mail Coalition did not address the issues of the appropriate level of volume variability of mail processing costs or the distribution of those costs to subclasses based on reasonable inferences of causation, as required by the Act and the Supreme Court in *National Association of Greeting Publishers v. United States Postal Service*, 462 U.S. 810, 827, 829 (1983), we support the position on these issues advanced by the periodical mailers in the Initial Brief of Alliance of Nonprofit Mailers, *et. al.*<sup>2</sup>

Application of the Single Subclass Stop Concept to Load Time and Multiple Subclass Stops. NAA endorses application of the single subclass stop concept to delivery carrier coverage load time, and further urges that the concept be expanded to encompass attribution of multiple subclass stops between the separate ECR and Regular subclasses of Standard mail. Joint Parties witness Crowder has thoroughly explained why the single subclass stop concept cannot be applied to coverage related load time costs. NAA hopes to evade the issue by claiming that Crowder's explanation should be disregarded because it is "quite complex" -- an implicit concession that NAA has no answer to her correct explanation.

It is NAA's proposal to attribute multiple subclass stop costs between the separate ECR and Regular subclasses that must be disregarded. The Commission has previously addressed and determined that multiple subclass stops cannot be attributed due to the lack of a sufficient causal link to a particular subclass. PRC Op. on Remand R90-1, at 55, ¶371. NAA's concept was not presented on the record, and there is

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<sup>2</sup> This issue is yet another instance where NAA's interest as a competitor is at conflict with the interests of publishers who use the mail to distribute their publications --including NNA, a participant in the periodical mailers' brief. NAA, in opposition to the publishers, urges that mail processing costs be treated as 100% volume variable. NAA Br. at 46. Its position, if successful, would raise the attributable costs and likely the rates of Periodicals and In-County mail, both of which are used by NNA members.

absolutely no evidence on this record, from NAA or anyone, to support a departure from that precedent. *Mail Order Association of America v. United States Postal Service*, 2 F.3d 408, 427-30 (D.C. Cir. 1993).

**I. THE POSTAL SERVICE'S PROPOSED RATES AND RELATIVE CONTRIBUTIONS FOR ECR MAIL ARE REASONABLE.**

**A. The Postal Service's Proposed Institutional Cost Allocations Are Reasonable, Sound, And Consistent With The Act.**

As noted in our initial brief, although one of the reclassification objectives in establishing ECR mail as a separate subclass was better recognition of the high price sensitivity of this mail in setting rates, ECR mail continues to have one of the highest institutional cost coverages of any subclass and a high unit contribution. At the Postal Service's proposed rates, ECR mail will have a cost coverage of 226 percent and make an average contribution of 8.3¢ per piece. USPS-15J. This is still substantially higher than that for the Standard A Regular subclass (154 percent cost coverage and 7.4¢ unit contribution). *Id.* It is also high in relation to First Class mail (199 percent cost coverage and 17.0¢ unit contribution).<sup>3</sup>

Even the OCA's testimony and brief lend support to the fact that the Postal Service's proposed ECR rates and cost coverages are reasonable. The Act requires consideration of a number of factors in setting postal rates, and does not mandate that rates be set solely on the basis of economic efficiency. Nevertheless, as the OCA observes, "the Commission should consider that departures from Ramsey prices have important welfare loss consequences." OCA Initial Br. at 167. OCA witness Sherman presented testimony that identified and estimated "the economic welfare advantages of

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<sup>3</sup> Under the Commission's costing methodologies, the relative coverages and contributions of ECR mail increase in relation to those for First Class, with a cost coverage of 211% versus 166%, and a unit contribution of 7.9¢ v. 14.0¢ -- a contribution that increases to 56% of the First Class contribution. Tr. 11183-85.

Ramsey prices over the prices proposed by the Postal Service.” OCA-T-300 at 3, Tr. 13710. “The remarkable property of Ramsey prices is that they minimize the resulting welfare losses” from having to set postal rates above marginal costs, by taking into account demand and costs. Tr. 13712.

Sherman’s analysis showed that the Postal Service’s proposed ECR rates are substantially higher than Ramsey prices, by a percentage far exceeding that of any other mail class or subclass. ECR mail “has a price almost twice as high as its constrained Ramsey [price]” -- 15.0¢ v. 8.1¢. Tr. 13730, 13728. The difference between the Postal Service’s proposed ECR institutional contribution and the Ramsey ECR contribution is also the greatest of any subclass. Tr. 13741.

No one suggests that postal rates should be set at Ramsey price levels. However, Ramsey prices still serve a useful role as an economically-based cross-check on rate levels and relationships. In the case of ECR mail, the Ramsey analyses of witnesses Sherman and Bernstein certainly counterbalance the claims of the competitors that ECR rates are “too low” or “unfair,” and particularly NAA witness Chown’s claim that ECR’s contribution to institutional costs is inadequate.

**B. Chown’s “Weighted Attributable Cost” Pricing Scheme Must Be Rejected.**

The myriad flaws in NAA witness Chown’s “weighted attributable cost” pricing “metric” have been addressed in detail in the Coalition’s initial brief, and in the briefs of the Postal Service and every other Standard A mailer party. In addition, the National Newspaper Association opposes Chown’s proposal. NNA Br. at 34-35. It has been obvious for some time that NAA’s interests in postal rates are strictly that of a competitor, not a mail user. Ironically, many NAA members use ECR mail to distribute their total market coverage products to nonsubscribers, although a number have switched to alternate delivery because ECR postal rates are too high to be competitive. Chown’s latest metric is simply another NAA contrivance to inflate ECR rates for

competitive gain -- even at the risk of harming newspapers that use ECR mail (both NAA and NNA members), the hundreds of thousands of businesses that use ECR saturation mail (particularly small businesses and individual entrepreneurs), all other ECR mailers, and ultimately all mail users.

1. **NAA's "Changed Circumstances" Rationale Is Invalid.**

A central premise of Chown's testimony is that the traditional approach to markups has resulted in a distortion of institutional cost contributions between classes, with First Class mail unfairly bearing an increasing burden while BRR/Standard A has escaped its fair share. On brief, NAA expands upon Chown's statements by asserting that the traditional method is no longer valid because of changes in mail mix and usage of the various postal functions over the years. After quoting Chown's statement that

"Applying a markup to total attributable costs is only appropriate if (1) all mailers buy approximately the same mix of the four basic functions or (2) the ratio of institutional costs to attributable costs is relatively constant across all four functions,"

NAA then concludes that "neither necessary assumption is true in *today's* postal system." NAA Br. at 9 n. 9 (emphasis added).

In fact, these supposedly "necessary assumptions" have *never* been true in the postal system. The ratio of "institutional costs to attributable costs" has *always* been substantially higher for the delivery function than for the mail processing function -- even moreso in the past than today.<sup>4</sup> Similarly, the mix of delivery-versus-mail processing attributable costs has always been substantially higher for BRR/Standard A mail than for First Class mail. And, the implicit cost coverage of the carrier route portion of

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<sup>4</sup> In Docket R84-1, the ratio of "institutional-to-attributable costs" was 13% for CS-3 mail processing and 269% for CS-7 city carrier delivery. PRC Op. R84-1 at Appendix J. In the Postal Service's R97-1 proposal, these ratios are 39% for mail processing and 242% for CS-7 delivery. USPS-15H (Patelunas).

BRR/Standard A, the segment targeted by Chown's proposal, has always been high. There is clearly no "changed circumstance" that warrants the use of an artificial re-weighting of attributable costs to shift more institutional costs onto ECR.

2. **The Unit Contribution "Gap" Has Narrowed. Not Widened As NAA Pretends.**

As further justification for the contention that its "weighted attributable cost" method is needed to rectify supposed distortions in institutional contributions, NAA alleges:

*"[The] gap between [First and Third Class/Standard A] unit contributions has steadily increased since 1984, in part because of the continued use of an unweighted approach in determining institutional assignments." NAA Br. at 12 (emphasis added).*

As support for this alleged "steadily increased gap" in unit contributions, NAA presents on brief a simplistic and misleading table that compares, on a nominal basis, the *absolute* differences between First- and Third-Class unit contributions since Docket R84-1. From this non-normalized comparison, NAA concludes that the unit contribution "gap" has grown from 5.47¢ in R84-1 to 9.64¢ in the Postal Service's R97-1 proposal.

To the contrary, *the true relative "gap" has steadily decreased*. The appropriate comparison is not the nominal, inflation-related absolute change in unit contributions, but the ratio of the BRR/Standard A unit contribution to the First Class unit contribution.<sup>5</sup> As shown below, under the Postal Service's proposed rates and costing methods, the Standard A unit contribution is 45.1% of the First Class unit contribution, up from 37.8% in R84-1. Under the Commission's past costing methods, the Postal Service's Standard

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<sup>5</sup> The mathematical fallacy of NAA's comparisons of the nominal unit cost differences over time is obvious. Assume, for example, that the BRR unit contribution steadily remained at exactly 40 percent of the First Class contribution over the entire period, but that both contributions increased by 100 percent over that time due to inflation. In that case, the nominal absolute "gap" cited by NAA would have "doubled" even though the real, inflation-adjusted gap is unchanged.

A unit contribution would be an even higher ratio -- 49% of the First Class unit contribution (Tr. 11161-63):

	<u>Unadjusted Unit Contributions, R84 to R97</u>			<u>True Ratio</u>
	<u>First Class Letters</u>	<u>Third Class Reg. Rate</u>	<u>Unadjusted Absolute Difference</u>	<u>3C Regular as % of 1C Letters</u>
R84-1	8.79	3.32	5.47	37.8%
R87-1	10.07	3.81	6.26	37.8%
R90-1	12.12	5.29	6.83	43.6%
R94-1	14.74	5.95	8.79	40.4%
R97-1 (USPS costs)	17.55	7.91	9.64	45.1%
R97-1 (PRC costs)	13.99	6.86	7.13	49.0%

Stated another way, the BRR/Standard A unit contribution has increased more rapidly over this period than has the First Class contribution, resulting in a narrowing of the "real" gap. NAA's premise -- that "continued use of an unweighted approach" has contributed to a "steadily increasing gap" in unit institutional cost contributions -- is simply false.

3. **The Proposed ECR Institutional Contributions Are, If Anything, Too High.**

NAA's focus on unit contributions exaggerates the significance of these comparisons. Although the Commission has noted that unit contribution comparisons are appropriate, it has never suggested that the third class/Standard A unit contribution should be anywhere close to that for First Class. Indeed, applying (or even moving toward) equal unit contributions would be tantamount to treating Standard A as a discount category of First Class mail, with rates based solely on cost differences -- completely ignoring Standard A's lower service standard and much higher price sensitivity, and producing an astronomical cost coverage far in excess of that for First Class. The Postal Service's rates do, in fact, produce fair and reasonable unit

contributions, taking into account the myriad of pricing factors that warrant substantially lower Standard A subclass contributions.

This is particularly true in the case of the ECR subclass within Standard Mail. Although NAA at times seems to forget, ECR is now a separate subclass to which the pricing factors of the Act must be independently applied. ECR's cost coverage and unit contribution are both high in relation to the Standard A Regular subclass -- 226% versus 154% cost coverage, and 8.3¢ v. 7.4¢ unit contribution -- notwithstanding ECR's clearly greater price sensitivity. Even compared to First Class, ECR's relative cost coverage and unit contribution are on the high side, taking into account both service and demand differences.<sup>6</sup>

4. **NAA's "Reweighting" Scheme Suffers The Same Flaws As The OCA's Discredited MC95-1 "Bypass Surcharge" Pricing Scheme.**

NAA disputes MOAA witness Andrew's statement that the Postal Service "does not sell functions," claiming that:

"Through the provision of presort and dropship discounts, the Postal Service essentially gives many mailers the choice of buying mail processing and/or transportation from either the Postal Service or a private alternative." NAA Br. at 17.

However, the mailers (and their customers) that NAA is specifically targeting for higher institutional costs -- ECR saturation mailers and their customers -- also have the choice of buying *delivery* "from either the Postal Service or a private alternative" -- thus bypassing the postal system entirely. A shift of institutional burden to these mailers risks losing their *entire* contribution by forcing them out of the system and into private alternatives. That, of course, is NAA's goal.

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<sup>6</sup> Under the Postal Service's cost methods, ECR's cost coverage is 27 percentage points higher than First Class, and its unit contribution is 49% of First Class. Under the Commission's cost methods, ECR's cost coverage is 45 percentage points higher than First Class, and its unit contribution is 56% of First Class. Compare USPS-15J and Tr. 11183-85.

NAA's arguments are reminiscent of the OCA's flawed "bypass surcharge" pricing arguments in Docket MC95-1, where OCA argued that customers who bypass functions prior to delivery should be assessed with additional costs, based on analogies to "stranded investment" and "backup" cost allocations in gas and electric utility ratemaking.<sup>7</sup> In its reply brief in that case, Advo exposed the fallacies of OCA's analogies:

"OCA's analogy is false. One crucial dissimilarity between these utilities and the postal system that OCA has ignored is the different nature of 'bypass.' In the gas/electric cases cited by OCA, the 'bypass customers' bypass only the energy sale and transportation services, not the ultimate 'local distribution' service. Both bypass and non-bypass customers are captives of the local distribution company (LDC) for this local distribution service. Because bypass customers cannot leave the system entirely, charging them for a portion of the stranded investment cost of the services they bypass does not risk losing those customers and their contribution from the system.

By contrast, in the case of third-class mail, there are segments of customers (high density carrier route mailers) that can bypass the postal system entirely by switching to the delivery services of newspapers and private delivery companies, or even by developing or acquiring their own private distribution operations. Unlike captive bypass customers of LDCs, the Postal Service risks losing the entirety of the contribution from these diverted customers. Given the competition that exists and the consequent greater price sensitivity of high density mailers, charging them a premium for the mail services they can bypass will only increase the likelihood that they will abandon postal delivery entirely in favor of the competitive alternatives." Advo Reply Br., MC95-1, at 6 (footnote omitted).

NAA's "weighted attributable cost" concept is, in fact, a variation on the OCA's flawed MC95-1 concept of imposing a fee or surcharge on customers who bypass non-

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<sup>7</sup> OCA Legal Memorandum, MC95-1, October 17, 1995. As used in the utility cases cited by OCA in its Legal Memorandum, "bypass customers" are large customers of the regulated local distribution company (LDC) who are able to "bypass *portions* of the distribution system (typically the generation and transportation of energy in the case of natural gas and electricity)." *Id.* at 37 (emphasis added). However, they do *not* bypass the LDC's ultimate "local distribution service." "Captive customers" differ from "bypass customers" in that they purchase from the LDC not only local distribution but also the generation and transportation of the gas or electricity from its origin to the LDC's local distribution network.

delivery functions. Whereas OCA advocated "includ[ing] a specified fee or charge solely in the rates set for the bypassing customers" (OCA MC95-1 Legal Memorandum at 56), NAA advocates that rates for ECR customers be set on the basis of a dramatically higher "reweighted" pricing base that reflects their bypass of non-delivery functions. As Advo stated in its MC95-1 Reply Brief:

"OCA claims that these [gas and electric utility pricing] principles 'must be applied to the current classification proceeding' to protect captive customers from the risk of 'failed bypassing arrangements' where a customer who leaves the postal system *entirely* (i.e., bypassing even the ultimate distribution service) later returns. [OCA Legal Memorandum] at 55. Its 'solution' is to 'include a specified fee or charge solely in the rates set for the bypassing customers.' *Id.* at 56."

"What OCA overlooks in the postal context is that (1) a customer that bypasses the entire postal system by switching to a competitor cannot be charged anything by the Postal Service, and (2) including an anticipatory 'bypass charge' in the rates of current customers because they have the ability to switch to competitors will only hasten their departure." *Id.* at 7.

OCA might be excused for having "inadvertently overlooked" these distinguishing characteristics of the postal system and ECR mail -- price sensitivity and availability of non-postal delivery alternatives. NAA, however, is keenly aware of them and knows better. The very objective of NAA's "weighted attributable cost" pricing redistribution is to "hasten the departure" of these price-sensitive ECR mailers and their customers, to the detriment of the postal system.

C. **NAA's Extra-Record Speculation That Shifting Institutional Costs From First Class To Standard A "Could" Deter Diversion To Technological Alternatives Is Unsupported, Wrong, And A Formula For Disaster.**

The absurdity of NAA's institutional cost arguments, and their outright threat to the continued viability of the postal system, is revealed in its remarkable and totally unsupported claim that shifting institutional costs from First Class to Standard A mail "could" be the solution to the diversion of First Class mail to technological alternatives:

"[S]uch an assignment of institutional costs *could* constitute a first step towards deterring the diversion of First Class mail to technological alternatives. *Record evidence suggests* that such threats to First Class *might* be significant. Professor Tolley's estimates of First Class volume took electronic alternatives into account in this case. *While one cannot speak with absolute certainty* on the effect that holding the line on First Class rates *could* have on deterring migration to electronic mail, the Postal Service *might* be at substantial risk if nothing is done to reduce the excessive institutional cost burden from First Class." NAA Br. at 28 (emphasis added).

First, NAA's own highly-qualified statement belies its suggestion that this threat of technological diversion is a function of First Class prices. NAA's tenuous connection to postal rates is sheer speculation.

Second, there is absolutely no evidence on this record that the level of First Class postal *rates* is a significant factor in this technological diversion.<sup>8</sup> Quite to the contrary, Saturation Mail Coalition witness Buckel testified that:

"The Postal Service faces growing competition for many segments of its business, including saturation mail. In other segments, *such as portions of First Class mail*, the competition comes primarily from new communications technologies that offer greater speed or convenience, *where price is less likely to be a decisive factor*. In the case of saturation mail, *the competition is a function of postal pricing*." SMC-T-1 at 16, Tr. 12093.

NAA did not question Buckel on this statement, and did not present any rebuttal testimony or evidence of any kind to support its contention that technology-related diversion is due to postal rates. Instead, NAA raises this false specter for the first time on brief, thereby avoiding the obligation (and embarrassment) of presenting and defending its assertions on the evidentiary record.

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<sup>8</sup> NAA's vague allusion that Tolley's volume estimates "took electronic alternatives into account" misconstrues Tolley's use of this information and misses the point. Although Tolley did discuss electronic alternatives, he did not conclude that their effect on volumes is a function of the level of First Class postal rates. Instead, he considered these factors as being encompassed within his net trend analysis, which he determined required no adjustment to his volume forecasts. USPS-T-6 at 51-61.

Third, the only other significant evidence submitted on this issue in recent years -- the testimony of witness Daniel Spulber on behalf of AMMA, MASA, DMA, and MOAA in Docket R94-1 -- found just the opposite. Based on his "careful economic analysis of the effects of pricing of first-class mail on electronic diversion," Spulber concluded that electronic diversion is "not sensitive" to changes in First Class rates:

"The argument that electronic diversion is sensitive to first-class postal rates is *fundamentally flawed* since it is inconsistent with technological and market developments in computers and telecommunications. As a consequence of these developments, electronic transmission provides a number of advantages that override any effects of small changes in the price of first class mail. Moreover, increasing diversion will take place as a consequence of ongoing technological and market changes. *It is important not to confuse this trend with price effects.*" R94-1 Tr. 9185-86 (emphasis added).

Spulber explained that the threat from technology is not price-related, but rather is due to technological and service-related advantages over mail.<sup>9</sup> Because of these differences, electronic alternatives "cannot be viewed as close substitutes" for First Class mail (*id.* at 9227-28) -- a conclusion that is even more compelling today.<sup>10</sup> As he stated:

"These ongoing and fundamental changes are entirely independent of postal rates. They can no more be diverted or slowed by a change in postal rates than a reduction in the cost of feeding horses would have halted the development of the automobile." *Id.* at 9195.

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<sup>9</sup> Spulber identified a number of the service/technology advantages of electronic alternatives over First Class mail, such as superior speed of communication (including not just near-instantaneous transmission but faster processing in sending and receiving information); interactive messaging; superior storage, indexing, retrieval, and data manipulation of messages and information; integration of "multiple media, text, data, voice, and images," "remote communication, information exchange and retrieval;" and avoidance of "many costly intermediate steps" required for paper communications and transactions." *Id.* at Tr. 9227-28. See also Tr. 9196-210.

<sup>10</sup> These substitutes are "less close" now than in 1994 when Spulber presented his testimony. Describing the state of technology at that time, for example, Spulber spoke of "16 megabit DRAM chips" (now 128 MB SDRAM chips), "150 megahertz" computer processors (now over 300 Mh), and "9600 baud modems" (now 56,000 baud and higher). Moreover, his testimony only hints at the subsequent explosion in use of the Internet by individuals and businesses for personal communications and business transactions. See generally *id.* at Tr. 9196-210.

The solution, Spulber concluded, was not to reduce First Class rates generally, but to “redesign ... postal products and services” and create “market-based product classes” that are more precisely attuned to market needs. *Id.* at 9226, 9228.

In stark contrast, NAA’s “solution” to this non-price-related threat of diversion to technological alternatives is a formula for disaster. To finance lower rates for First Class mail, where the effect of lower rates in stemming diversion is fanciful and would only serve to reduce Postal Service revenues, NAA would substantially increase the rates for price-sensitive ECR mail, where the negative effect on volumes is certain. Instead of averting diversion of First Class mail, NAA’s solution would simply assure the diversion of ECR mail.

The threat of technology is real, but NAA’s self-serving solution is not the answer. In the real world, a business faced with technological threats to one of its major product lines would try to (1) more finely segment that product line by developing “market-based product classes” to compete for segments of that business, and (2) focus on improving the competitiveness of other existing product lines that offer opportunities to offset some of the lost revenues. Saturation mail, as Buckel explained, offers such an opportunity provided that it is priced competitively:

“The Postal Service’s future in the saturation mail market depends on postal pricing decisions. The current saturation mail volumes and contribution cannot be taken for granted. Without affordable rates that allow mailers to compete in the marketplace, the Postal Service risks losing this price sensitive volume to newspaper competitors and to new or expanded private delivery operations. Existing mailers may also be forced to shift to private delivery, just as occurred following the Docket R87 rate increase.

With affordable rates, saturation mail growth from existing mailers, and from former mailers that previously switched to private delivery due to increased postal rates (particularly the high pound rate), *can offset declines in other volumes due to changes in communication technology.*” SMC-T-1 at 16, Tr. 12093.

**D. Competitive Considerations Do Not Warrant Any Adjustment To The Postal Service's Proposed ECR Rates.**

In its just-issued decision in the Provisional Packaging Service case, Docket MC97-5, the Commission discussed a number of concerns about the effect of that new service on competition. Because other competitors competing for traditional postal services may be tempted to use that decision to press competitive arguments in this case, we believe it is important to distinguish those issues from the competitive issues before the Commission in this docket.

The most obvious and decisive distinction is that the delivery of advertising mail is not a new ancillary service tangentially related to the USPS's core services, as the new packaging service arguably was. The Postal Service has been in the business of delivering advertising matter for over a century. It is not an interloper into a market that has traditionally been the domain of private businesses. Delivery of advertising matter is part of the Postal Service's "core services."

Nor is the competitive issue in the advertising distribution market a matter of "big versus little." The dominant competitors in this market -- the newspaper industry -- include a number of Fortune 500 companies, and at the local level newspapers are the dominant advertising medium in virtually every market. The saturation mail industry itself includes thousands of small mailers providing saturation mail services, as well as small franchisees and other independent mailers for whom the mailing business is their "bread and butter." The membership of the Saturation Mail Coalition reflects this diversity of size, with many small mailers like the Antigo Shoppers Guide in Antigo, Wisconsin, who serve rural markets with weekly circulation to less than 20,000 households. SMC-T-1 at 4 (Buckel). Similarly, the customers of saturation mail are mostly small businesses and individual entrepreneurs who depend on the mail for their livelihoods.

Commissioner LeBlanc in his dissenting opinion expressed strong concern that "the Postal Service now proposes to enter as a new competitor" into a market "currently being served by more than 10,000 private businesses." Dissent at 1.

"I am not yet convinced that an agency of the federal government . . . should be going head-to-head with many small business people who have invested their own 'sweat equity' and capital into a business that is their livelihood." Id. at 3.

Whatever its validity with respect to the new packaging service, these concerns about new entry into an existing market served by small businesses is not applicable to the saturation mail market. Saturation mailers have been using the mail and competing in the marketplace for decades, long predating postal reorganization. Many saturation mailers are themselves "small businesses" run by "people who have invested their own 'sweat equity' and capital into a business that is their livelihood." There are hundreds of thousands of small businesses and entrepreneurs who use and depend upon saturation mail to generate customers and who likewise have a stake in affordable, competitive saturation mail rates.<sup>11</sup>

## **II. THE PROPOSED REDUCTION IN THE ECR POUND RATE IS SUPPORTED BY THE INDUSTRY AND THE EVIDENTIARY RECORD.**

The Postal Service's proposed reduction in the ECR pound rate has the unanimous support of the mailing industry. The supporters include flat and letter mailers, saturation and non-saturation mailers. Even Val-Pak, a saturation letter mailer that in MC95-1 was the only mailer party that opposed the lower pound rate, now

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<sup>11</sup> In recommending a "system average" cost coverage for the new packaging service, the Commission, while noting concerns about the Postal Service's competitive advantages in entering a new market competing with small firms that have traditionally offered such packaging services, also cited the "high intrinsic value" of the packaging service, as well as concerns about providing a sufficient cost coverage buffer to "protect against the contingency that costs may prove to be higher, or increase, during the provisional service period." PRC Op. MC97-5 at 49. These concerns are not applicable to ECR mail services.

endorses the proposed pound rate as “conservative.” Val-Pak Br. at 11-13. The only opposition comes from competitors, NAA and AAPS.

NAA in its initial brief says nothing further about the pound rate issue except that it “will not repeat here” the arguments in its March 26 Memorandum of Law on the Pound Rate. NAA Br. at 5. Those arguments do not warrant repeating. They were thoroughly rebutted in the Saturation Mail Coalition’s initial brief at 22-45; and in the initial briefs of MOAA at 23-38; AISOP at 3, 12-13; and the Postal Service at V-152-58.

In our initial brief, we noted a glaring omission in NAA’s lengthy memorandum -- its curious failure to address the rebuttal testimony of Advo witness Crowder concerning the pound rate.

“It may be that NAA has said all that it can or dares say about Crowder’s testimony, or that it intends to address her testimony in its initial brief. On the other hand, it may be that NAA intends for tactical reasons to hold its fire until reply brief, thereby depriving other parties of an opportunity to respond to its reply ‘criticisms.’” SMC Br. at 22

It remains to be seen if NAA will respond. If so, judged by its legal memorandum and initial brief, filled with skewed interpretations and twists of the record, new testimony in the guise of argument, and casual and selective treatment of the evidence, its arguments should be read with caution and skepticism.

AAPS, the only other party opposing the pound rate, attempts on brief to “rebut” Crowder’s analysis demonstrating that weight is not a significant factor on city carrier loops. Its arguments, however, are so confused and fragmented as to be nearly impenetrable.

First, AAPS claims that in assessing the effect of weight on *loop* costs,

“The relevant number ... is what percentage of stops are on loops with 40, 50, or 60 stops, not what percentage of loops have that many stops.”  
AAPS Br. at 4.

This is nonsense. The costs that both AAPS witness Bradstreet and Crowder were addressing were *loop* costs, not stop costs. The likelihood that a given increase in

weight per stop will cause a carrier to exceed his satchel capacity and incur extra loop costs (assuming no deferral) is entirely a function of the percentage of total loops that exceed the satchel-threshold number of stops per loop. AAPS's "percentage of stops on loops with 40 stops" is irrelevant. If loops of that threshold size or larger constitute only 10 percent of total loops, then extra *loop* costs would be incurred on only 10 percent of the carriers' loops, regardless of the "percentage of stops" on those loops.

Second, AAPS constructs yet another hypothetical that is sillier and more extreme than Bradstreet's original hypothetical. As far as we can discern, AAPS's hypothetical asks us to assume that (1) *if* the proposed pound rate were low enough to make it economical for Mr. Buckel to shift his heavy-weight privately-delivered shopper into the mail (the answer is no), and (2) *if* the particular mailing had a piece weight of 1-pound each (the absolute maximum ECR weight), and (3) *if* the mailing is going to a loop with 40 stops, and (4) *if* all of the 40 pieces for that loop had to be delivered on the same day, without deferral of a portion to the next day, then those 40 1-pound pieces would add 40 pounds to the loop, exceeding the carrier's satchel limit. AAPS Br. at 4, n. 6. This only proves that anyone can dream up ridiculous scenarios that have nothing to do with the real world or the record evidence in this case.

Third, AAPS's bald characterization that Crowder "relies upon conjecture and assumptions rather than facts," and that her conclusions are "pure speculation" (*id.* at 4-5) is laughable. Unlike Bradstreet, Crowder presented a thorough description and analysis of the realities of carrier loop-related activities, supported by studies, data, and personal observation of carrier activities. Bradstreet presented only simplistic and absurd hypotheticals. It is Bradstreet's conclusions that are "pure speculation" and "conjecture" unsupported by facts.

Finally, AAPS claims the McGrane study produced "absurd" results. *Id.* A review of the transcript pages cited by AAPS reveals that these all deal with ounce-to-ounce variations in the cost curve, all of which were specifically addressed in Crowder's

rebuttal testimony and most of which either disappeared or smoothed out as a consequence of Crowder's refinements to McGrane's analysis. See Tr. 18320-21 and SMC Initial Br. at 16-18.

The most significant aspect of AAPS's arguments is not what little it does say, but what it doesn't say. Nowhere does AAPS suggest that postal costs in general, or even delivery costs specifically, are 100% weight-related, as implied by the current pound rate structure for saturation mail. AAPS's own witness Green conceded that weight is a relatively insignificant factor in private delivery costs ("we haven't been concerned with weight for so long since we're in the hand delivery," Tr. 11973). He also conceded that the current pound rate "would make it prohibitive" to mail his privately-delivered publication. Tr. 11970. Without a case on the merits, AAPS simply kicks up dust in the hope of clouding the issue. Even at that level, it has not succeeded.

**III. THE POSTAL SERVICE'S PROPOSED ECR DENSITY DISCOUNTS ARE WELL SUPPORTED, REASONABLE, AND CONSERVATIVE -- NOTWITHSTANDING NAA'S FLAWED NEW TESTIMONY ON BRIEF.**

NAA witness Donlan's direct testimony, consisting of 12 pages, critiqued two aspects of the Postal Service's proposed ECR high-density and saturation density discounts.

- First, he claimed that the estimated mail processing cost differences for flats were overstated because they failed to "properly account for the impact of new ECR preparation and entry requirements." He presented an analysis of post-reclassification costs showing a lower cost for ECR basic flats and a consequent lower flat cost differential.
- Second, he claimed that the estimated delivery cost for ECR basic letters "fails to account for DPS-related delivery cost savings," and thereby results in overstated letter cost differentials. NAA-T-2 at 10.

These two arguments were rebutted by Advo witness Crowder (ADVO-RT-1 at 25-36, Tr. 18333-44), and were addressed in our initial brief (at 47-49).

On brief, NAA has tried to resuscitate Donlan's weak arguments and reinforce them with new arguments that are, in fact, late-filed direct testimony. Those new arguments should be rejected for that reason alone; in any event, they are meritless.

A. **For ECR Letters, Density-Related Cost Differences More Than Cover The Postal Service's Proposed Discounts.**

For ECR letters, the Postal Service estimated a cost difference of 3.11¢ per piece between saturation and basic-rate letters, consisting of a 1.59¢ mail processing cost difference and a 1.52¢ delivery cost difference. USPS-29C at 4 (revised 10/1/97). In his testimony, Donlan did not mention letter mail processing costs. His only criticism of the Postal Service's letter delivery costs was the claim that DPS-processed letters had not been given credit for DPS in-office casing savings, and that this caused an overstatement of the density-related cost differences.

1. **The Same Cost Analysis Witness Donlan Used For ECR Flats Shows That ECR Letter Mail Processing Cost Differences Are Substantially Understated And Exceed The Proposed Discounts.**

In the case of ECR *flats*, Donlan claimed that the USPS mail processing cost differences were overstated, citing post-reclassification cost data showing a lower cost for basic-rate flats than in the FY 1996 cost data used by the Postal Service. Tr. 14676-78. However, in the case of ECR *letters*, Donlan made no mention of post-reclassification mail processing costs, for obvious reasons. What Donlan carefully ignored in his testimony, and NAA carefully ignores on brief, is that the same post-reclassification cost analysis Donlan performed to show a *decline* in the saturation *flat* mail processing cost differential also shows a substantial *increase* in the saturation *letter* cost differential, due to *higher* post-reclassification unit costs for basic ECR letters.

Compared to the FY 1996 letter mail processing cost difference of 1.59¢ used by Moeller, the post-reclassification cost difference is 3.23¢. Tr. 18339-40 (Crowder). This

mail processing cost difference alone is greater than the 3.0¢ saturation letter discount proposed by Moeller, even without considering delivery cost differences. On this basis alone, there is ample cost evidence (ignored by NAA) to support Moeller's saturation letter discount.

2. **NAA's New Testimony on Brief Concerning In-Office Letter Casing Productivities And Costs Is Not Only Improper But Incorrect: The Postal Service's Delivery Cost Differences Are, If Anything, Understated.**

In addition to mail processing cost differences (which Donlan's own approach indicates are understated), the Postal Service also estimated a 1.52¢ unit delivery cost difference between saturation and basic letters. This is where NAA focuses its attention, raising new arguments on brief that the delivery cost difference is overstated because of post-reclassification changes in operations and handling, and speculating that the actual delivery cost difference "could well be zero (or negative)." NAA Br. at 34. NAA's one-way use of reclassification effects is transparent: it ignores increased letter *mail processing* cost differences under its own witness's approach, yet alleges (tardily and incorrectly) reduced letter *delivery* cost differences.

In its initial brief, perhaps sensing the weakness of Donlan's arguments, NAA for the first time presents a number of new extra-record arguments. It asserts that USPS witness Hume's use of witness Shipe's Docket R90-1 casing productivities ignores the "very different operating conditions" underlying those productivities, and consequently "greatly overstates the in-office delivery cost differences among the presort tiers for both non-letters and letters." NAA Br. at 30. Referring to witness Crowder's rebuttal testimony that showed in-office delivery cost differences alone are sufficient to justify the Postal Service's non-letter presort discounts, NAA then states: "However, as *demonstrated below*, these differences are overstated for both ECR letters and non-letters." *Id.* at n. 30. NAA then launches into presentation of its new (and quite late) surrebuttal testimony.

These new assertions illustrate precisely why testimony is required to be presented on the evidentiary record rather than on brief.<sup>12</sup> NAA's new testimony, in the guise of argument, incorrectly interprets and misuses Shipe's data, misunderstands the effect of new operating conditions on the relevant productivities, and ignores more recent data that refute its new testimony. Among the many flaws in NAA's analysis are the following:

- Shipe's R90-1 productivities were all based on the casing of high-density and saturation mailings having at least 125 pieces per route -- *not* on the productivity of casing low-density basic-level carrier route mailings having as few as 10 pieces per route.
- Shipe's substantially higher productivities for saturation walk-sequenced v. 125-piece walk-sequenced mailings demonstrate that the cost savings for similarly-sequenced mail vary dramatically with address density. These same density-related productivity differences appear in Shipe's data for every other sequencing method, including the sector segment and street-sequenced methods NAA now claims as the proper productivity proxies for low-density basic ECR mail.
- Shipe's letter and flat productivities indicate that the cost savings from *any* method of address-sequencing are relatively small for ECR basic-level mailings with low address *density* -- a known phenomenon that is a consequence of the greater "search and reach" time required for casing only a few scattered pieces of low-density mail into a carrier case with hundreds of address slots.
- Shipe adjusted his R90-1 *flat* productivities upward substantially, on the assumption that the expected use of vertical flat cases (VFC) would result in substantially *reduced* casing costs compared to conventional cases. R90-1, USPS-10B at 4. But as shown in Docket MC95-1, the use of vertical flat cases has had only a modest effect on flat casing productivities and unit costs. USPS LR PBC-2.

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<sup>12</sup> Nowhere in NAA witness Donlan's brief testimony is there any mention of carrier in-office casing productivities, or Shipe's R90-1 analysis, or NAA's new claim on brief that Hume should have instead used different casing productivities.

- Shipe made no adjustment to his R90-1 *letter* productivities to account for vertical flat cases. But as shown in MC95-1, the use of vertical flat cases has actually substantially reduced the casing productivities and increased the costs of non-automated letters. USPS-RT-5 (Lewis), MC95-1.
- Shipe's R90-1 letter and flat productivities ignore that many saturation letters and flats (1) may not be cased in-office, and (2) have density-related out-of-office loading efficiencies at multiple delivery stops, and that some saturation flats are not loaded at all. R90-1, ADVO-RT-2, at IV-2, Tr. 20746, 20810-15, 20824-25, 20831 (Crowder).
- There are still a substantial number of zones (53%) that are not automated (NAA/USPS-T4-19). Even in automated zones, there are substantial volumes of automated high-density and saturation letters. Tr. 18340-18343 (Crowder), 15044-45, 10547 (Haldi).

Had NAA presented its new arguments on the record as part of Donlan's direct testimony, these numerous flaws and others would have been demonstrated on the record through discovery, cross-examination, and rebuttal. Given the obvious weaknesses in NAA's new arguments, it is no surprise they were not presented as sworn testimony. The specific flaws are discussed below.

a. **The Alleged Effect of Line-of-Travel Sequencing on Basic-Rate ECR Costs.**

On brief, NAA asserts that USPS witness Hume's use of Shipe's R90-1 casing productivities overstates density-related cost differences because ECR basic-rate mail is now required to be entered in line-of-travel sequence, not unsequenced as Shipe assumed. It then claims:

“Accordingly, one might have expected Mr. Hume to make use of productivities calculated by Mr. Shipe in Docket No. R90-1 for mail which is segment/sector sequenced and street sequenced.<sup>33</sup> These productivities should better reflect the relative casing speed for ECR basic letters and flats, given the required line-of-travel sequencing, and not surprisingly were greater than the productivities used by witness Hume for ECR basic mail. The use of these higher productivities for basic mail would have greatly reduced the cost differences between the tiers.

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<sup>33</sup> These sequencing methods are similar to line-of-travel sequencing. These productivities were 25 to 35 percent higher for both flats (Docket No. R90-1, Exhibit USPS-10B, at 4) and letters (Docket No. R90-1, Exhibit USPS-10B, at 6).” NAA Br. at 32 and n. 33.

This new claim on brief flagrantly misinterprets Shipe’s productivity analysis and misuses his data. In reality, for basic-rate ECR letter and flat mail, the line-of-travel requirement generates minimal cost savings compared to unsequenced mail.

What NAA overlooks is that Shipe’s segment/sector and street sequenced productivities that it now claims should be applied to basic-rate ECR mail are, in fact, inapplicable to such mailings. Those productivities were instead based on the casing of *high-density 125-piece mailings*. All of Shipe’s productivity tests for sequenced mail were based on the casing of high-density and saturation density mailings that had at least 125 pieces per route. USPS-10A at 1, 6, R90-1. On their face, those high-density mailing casing productivities are not representative of low-density basic-level ECR mailings having as few as 10 pieces per carrier route.<sup>13</sup>

Shipe’s productivities clearly demonstrate that a mailing’s address density is a far more important casing productivity factor than the type of address sequencing. For each type of sequencing method tested by Shipe, the casing productivities for

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<sup>13</sup> On a typical route with 500 addresses, it is common sense and common operational knowledge that the per-piece casing efficiency for a 10-piece mailing, no matter how sequenced, will be much lower than that for a sequenced 125-piece mailing, because of the slower “look and reach” time between widely scattered low-density addresses – for the same reason that the casing efficiency for a walk-sequenced 125-piece mailing is substantially lower than that for a walk-sequenced saturation mailing, as shown in Shipe’s analysis. R90-1: USPS-T-10 at 10-11; Tr. 20821-23 (Crowder).

saturation-density mailings were in every instance from 30% to 50% greater than for the comparably-sequenced 125-piece mailings (USPS-10B at 4 and 6, R90-1):

Extent To Which Saturation Casing Productivities Exceed 125-Piece Productivities

<u>Sequencing Method</u>	<u>Flats</u>		<u>Letters</u>	
	<u>Flats</u>	<u>Calculation</u>	<u>Letters</u>	<u>Calculation</u>
Walk-Sequenced	50.5%	(27.4/18.2)	42.1%	(41.2/29.0)
Segmented-A	29.3%	(21.2/16.4)	27.7%	(33.2/26.0)
Segmented-B	37.8%	(23.7/17.2)	34.5%	(37.0/27.5)
Street Sequenced	29.8%	(22.2/17.1)	26.7%	(34.6/27.3)

This density-related difference in productivities applies as well to lower densities below 125-piece. Indeed, for a minimum 10-piece basic-level ECR mailing, the casing productivity into a 500-address case would not be noticeably different for unsequenced than for line-of-travel sequenced mail, given the substantial "search and reach" effort between widely dispersed addresses. If one *conservatively* assumed that, for any specific type of sequencing, the high-density 125-piece productivity is 30% greater than the low-density basic-level productivity, the resulting basic-level productivities would be as follows (based on USPS-10B at 4 and 6):

<u>Sequencing Method</u>	<u>Flats</u>	<u>Flats</u>	<u>Letters</u>	<u>Letters</u>
	<u>PPM</u>	<u>Calculation</u>	<u>PPM</u>	<u>Calculation</u>
Segmented-A	12.6	(16.4/1.3)	20.0	(26.0/1.3)
Segmented-B	13.2	(17.2/1.3)	21.2	(27.5/1.3)
Street Sequencing	13.2	(17.1/1.3)	21.0	(27.3/1.3)

These are quite close to the productivities that Shipe actually calculated for non-sequenced flats (13.2 pieces-per-minute) and letters (20.6 pieces-per-minute). Id.<sup>14</sup>

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<sup>14</sup> This does not mean that the line-of-travel sequencing requirement has generated zero cost savings, but only that those savings are quite small for low-density mailings and nowhere near the high-density mailing productivities erroneously claimed by NAA to be "proxies" for basic-level line-of-travel sequenced mailings.

b. **The Alleged Effects Of DPS and Vertical Flat Casing Methods On Casing Productivities.**

NAA further suggests that the introductions of DPS processing and the use of vertical flat cases since Docket R90-1 have caused increases in casing productivities which were not recognized in Shipe's analysis or the Postal Service's cost estimates in this case, leading to an overstatement of density-related cost differences. NAA Br. at 30 and n. 29. Had NAA looked further or subjected its contentions to scrutiny on the record, it would have discovered just the opposite: increases in DPS processing and use of vertical flat cases have caused a decrease in casing productivities, and an understatement of casing cost differences.

The Postal Service has acknowledged that Shipe's R90-1 analysis overstates casing productivities. Shipe assumed that introduction of vertical flat cases would cause a substantial increase in flat casing productivities compared to the conventional casing productivities measured in his tests. He assumed that by the FY 1992 test year, 86% of all flats would be cased into vertical flat cases, and that casing productivities at vertical flat cases would be 28% greater than at conventional flat cases. USPS-10B at 4, R90-1. Consequently, his final weighted flat casing productivities were substantially higher than the conventional casing productivities he measured (except for saturation walk-sequenced mail which was not adjusted). Shipe, however, did not adjust his letter casing productivities to reflect the effect of vertical flat cases.

Subsequently, in Docket MC93-2, the Postal Service presented casing productivities based on actual operational conditions. USPS LR PBC-2. Those results showed that, contrary to Shipe's assumptions, flat casing productivities were essentially the same for both vertical flat cases and conventional cases, not 28% higher. For letters, casing productivities were actually substantially lower for vertical flat cases than for conventional cases. Moreover, as the proportion of DPS-processed letters increased,

the letter casing productivities for the remaining non-DPS letters declined even further. USPS LR PBC-2 at 7, Docket MC93-2:

% DPS <u>Letters</u>	<u>Casing Productivities (Pieces per Minute)</u>			
	<u>Letters</u> <u>Conventional</u>	<u>Letters</u> <u>VFC</u>	<u>Flats</u> <u>Conventional</u>	<u>Flats</u> <u>VFC</u>
22%	18.0	15.5	10.4	10.3
46%	15.9	13.1	10.7	10.0
62%	13.6	12.1	10.0	10.2

This, of course, refutes NAA's two key points.

First, Shipe's ECR flat casing productivities are likely overstated. While he assumed that use of vertical flat cases would increase casing efficiency by 28%, the above actual results indicate no increase in efficiency. Thus, Shipe's analysis understated flat casing costs and cost differences.

Second, Shipe's letter casing productivities, which were unadjusted for vertical flat cases, are too high in light of the above results showing that letter casing productivities decline as (a) the proportion of DPS volume increases and (b) the proportion of vertical flat case usage increases. In Docket MC95-1, USPS witness Lewis confirmed this overstatement of letter casing productivities:

"[M]anual productivity for all letters requiring in-office casing *declines significantly* when casing non-automated letters into vertical flat casing equipment with the flats, as was shown in the DPS Work Methods Study." USPS-RT-5 at 3, Docket MC96-5 (emphasis added).

"[O]ne effect of these ongoing changes in the Postal Service's delivery environment is to further narrow the differential between manual letter and flat casing productivities to the point that the difference is negligible." *Id.* at 17.

"Witness Shipe did not test casing letters into vertical flat cases, nor did he adjust his letter casing productivities to account for the use of vertical flat cases for sorting letters. Thus, witness Shipe's productivity figures for letters *are not representative* of a delivery environment where non-automated letters are cased into vertical flat cases. Indeed, even witness Haldi agrees in his response to ADVO/VP-T1-13 that the manual letter casing productivities will *decline* when non-automated letters are cased

into vertical flat casing equipment with the flats.” *Id.* at 18-19 (emphasis added).

Thus, Shipe’s analysis, and Hume’s present analysis, likewise understated letter casing costs and cost differences.

**c. DPS Effects on the Density-Related Letter Costs.**

NAA also asserts that the in-office costs for basic-rate letters are overstated because the cost savings associated with DPS-processing of those letters is not recognized. NAA Br. at 32-34. This also is misleading, and misconstrues how USPS witness Hume developed his in-office costs and cost differences.

With witness Crowder’s explanation that DPS cost savings associated with non-automation ECR letters are embedded in witness Hume’s costs, NAA appears to have abandoned Donlan’s claim that DPS cost savings were not attributed to non-automation ECR letters. On brief, NAA concedes that “it is true that the *average* base year costs for ECR letter mail may implicitly include these cost savings,” but states that “discounts are based upon *cost differences* - not average base year letter costs.” NAA Br. at 33. However, NAA then incorrectly asserts that Hume’s density-related cost differences were “based solely upon differences in Mr. Shipe’s R90-1 productivities, that fail to reflect the cost savings associated with DPS processing of letters.” *Id.* at 33-34.

Crowder explained why this is incorrect. Shipe in R90-1 simply calculated the cost differences by directly dividing the carrier average wage rate by his productivity differences. Hume, on the other hand, started with actual FY 1996 carrier in-office letter costs that already included the effects of DPS cost savings, and then deaveraged those costs into separate costs for each density tier by applying the *ratios* of Shipe’s productivities (rather than applying Shipe’s absolute productivity *differences* as NAA seems to believe). Tr. 18341-43 (Crowder). This method scales the resulting unit costs for each tier to reflect the DPS-related cost savings included in the base year costs, and likewise scales the unit cost *differences* between tiers. Thus, cost reductions due to

DPS reduce not only the base year and test year costs but also the density-related cost differences. As Crowder stated:

“USPS witness Hume ... calculates unit delivery costs for the four rate categories of ECR letters. He de-averages base-year attributable delivery costs for ECR letters and then projects them to the test year along with their piggybacks. Since base-year mail processing cost data show that all categories of ECR letters experience automation, then it follows logically that all automation-related delivery cost savings associated with that volume are included in base-year delivery costs. Thus, both non-walk-sequenced and walk-sequenced letters are credited with automation-related delivery cost savings experienced during the year. And, by starting with delivery costs which implicitly include these cost savings, witness Hume has implicitly included them in his analysis of ECR letter delivery costs.

“. . . [T]o the extent there are DPS delivery savings for ECR letters, he has included them in the base and test year unit delivery costs *for each non-automation-rate ECR letter category.*” Tr. 18341-42 (emphasis added, footnotes omitted).

While the delivery costs for a saturation-rate and a basic-rate mailing that are both DPS-processed would be the same, Crowder explained that this did not mean that, for the entire subclass, there would be no delivery cost difference between saturation-rate and basic-rate volume.

“What we’re talking about now is a weighted average [for the entire subclass]. Part of the weighted average is the non-DPS casing, which comes from Witness Shipe.... And the other part of the weighted average is the DPS processing.” Tr. 18411.

As Crowder explained, Hume’s analysis correctly produced a weighted average unit cost (and cost differentials) for all three non-automation letter density levels. She demonstrated that NAA’s assertion that the delivery cost for non-walk-sequenced letters is too high relative to that for walk-sequenced letters is simply wrong.

NAA speculates, on brief, that “the percentage of ECR basic letters that are DPS processed likely exceeds the percentage of high-density and saturation letters that are DPS processed,” and that consequently “many ECR basic letters” will have “lower in-office delivery costs compared to high-density/saturation letters.” NAA Br. at 34 n. 34.

It gives no record citation for this claim other than an allusion to the Postal Service's "effort to 'identify and capture' ECR basic letter mail for DPS processing." This apparent reference to USPS witness Moden's testimony, mischaracterizes what he said. Moden was referring to the effort to identify and capture "non-barcoded" basic letter mail "in order to barcode them at the plant." USPS-T-4 at 8. He was not suggesting that the Postal Service did not DPS-process other mailer-*prebarcoded* ECR mail. In fact, the Postal Service's policy has been to "DPS all prebarcoded carrier route presort mail" whenever possible. LR MCR-64, p. 1 (MC95-1).

The evidence on this record indicates that a high percentage of ECR high-density and saturation letters are DPS-prebarcoded by mailers, and that the percentage of this mail that is DPS-processed is therefore likely comparable to or greater than the percentage of ECR basic letters that are DPS-processed.<sup>15</sup> The Postal Service has an incentive to DPS-process such prebarcoded high volume mail because it (1) requires no extra barcoding operation, (2) is high density mail, and (3) facilitates the Postal Service's ability to achieve threshold or target DPS volume levels for conversion to the preferred vertical flat casing method. NAA/USPS-T4-5, USPS-T-4; MC95-1: USPS-RT-5 (Lewis).

This high proportion of mailer prebarcoding has three other implications. First, the prebarcoded high-density and saturation letter mail that is DPS-processed by the Postal Service is lower-cost than non-prebarcoded basic letter mail which must go through the extra barcoding operation. Second, a portion of the prebarcoded saturation letter mail that is not DPS-processed still avoids in-office carrier casing and produces

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<sup>15</sup> For example, Val-Pak, the nation's largest saturation letter mailer, DPS-prebarcodes 100% of its 360 million walk-sequenced saturation letter pieces. Tr. 15044-45 (Haldi). Similarly, Carol Wright DPS-barcodes 100% of its 300 million pieces, most of which are walk-sequenced high-density letters. *Id.* at 15047. The DPS-prebarcoded volumes of these two mailers comprise perhaps one-fourth of total system high-density/saturation letter volumes.

density-related loading efficiencies at multiple-delivery stops, at a lower total cost than DPS-processed basic letters. Tr. 15185 (Haldi); see also Docket MC95-1 at Tr. 8348 (Haldi). Third, DPS processing does *not* sequence mail for multiple-delivery stops, such as apartment buildings where all mail must be loaded (cased) into receptacles at the stop. MC95-1: USPS-RT-5 at 19-20. For such stops, walk-sequenced mail has a lower casing cost than basic letter mail that has been DPS-processed (but not sequenced).

**B. For ECR Flats, Density-Related Cost Differences Far Exceed The Postal Service's Proposed Discounts.**

NAA has not seriously challenged the Postal Service's proposed 2.3¢ discount for saturation flats compared to basic-level flats. That saturation flat discount, in fact, represents barely a 50% passthrough of the USPS-estimated 4.4¢ cost difference.<sup>16</sup> This passthrough was constrained by other rate design decisions, including the letter-nonletter rate differential and passthrough, and the saturation letter discount and passthrough. No matter how NAA might try to play with the numbers, these flat discounts are not only cost-justified but quite conservative.

**1. Even Witness Donlan's Analysis Shows Substantial Mail Processing Cost Differences That Cannot Be Ignored.**

For ECR flats, the Postal Service estimated a cost difference of 4.42¢ per piece between saturation and basic-rate flats, consisting of a 2.07¢ mail processing cost difference and a 2.35¢ delivery cost difference. Donlan's criticism of the mail processing cost estimate was that it is too high based on his analysis of post-reclassification costs and cost differences. His post-reclassification analysis showed that the mail processing costs of all three density tiers had declined, but with the largest

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<sup>16</sup> Witness Daniel's revised unit costs show a 2.76¢ cost difference between basic and high-density ECR flats, and an additional 1.66¢ cost difference between high-density and saturation flats, for a total basic-saturation cost difference of 4.42¢. USPS-29C at 2 (revised 10/1/97). Moeller proposed passthroughs of only 40% of the basic-high density difference and 72% of the high density-saturation difference, or an overall passthrough of only 52% of the total basic-saturation cost difference. USPS-T-36 at 48 (revised 10/3/97).

decline for basic flats, reducing the saturation-to-basic mail processing cost differential from 2.07¢ to 1.46¢. He did not rebut the Postal Service's estimated 2.35¢ *delivery* cost differential for flats.

From this, Donlan leapt to the conclusion that the Postal Service's discounts for flats should be rejected and the current discounts left unchanged, ignoring the low passthrough inherent in the Postal Service's proposal. He also ignored the fact that the Postal Service's 2.35¢ delivery cost differential -- which he did not rebut -- was alone greater than the proposed 2.3¢ discount.

2. **There Are Significant Density-Related Delivery Costs For Flats That Fully Support The Proposed Discounts.**

In his testimony, Donlan did not challenge the Postal Service's estimated delivery-related cost differences for ECR flats, but focused on DPS-related costs for ECR letters. Only on brief has NAA now belatedly tried to question the delivery costs for flats, based on its new arguments described above in the sections discussing the delivery-related costs for letters.

Of these new arguments, the only ones even remotely applicable to flats are NAA's contentions concerning the effects of line-of-travel sequencing and the introduction of vertical flat cases. These arguments, as discussed above, are spurious. Even accepting Donlan's reduced 1.46¢ estimate of mail processing cost differences (which NAA apparently contends should be ignored), and discounting for the gross flaws in NAA's new delivery cost arguments, there can be absolutely no question that the Postal Service's proposed density-related flat discounts are modest in relation to cost differences.

In sum, the Postal Service's proposed density-related discounts are exceedingly reasonable. For non-letters, even with no recognition of the relevant mail processing cost differentials, the density-related discounts are supportable on the basis of very conservatively developed delivery cost differentials alone. Tr. 18337-38. For letters, the

density-related discounts are supportable on the basis of both the USPS estimated costs and USPS policy of encouraging efficient conversion of ECR basic-rated letters to the Automation 5-Digit and Carrier Route categories. Tr. 18343-44.

**IV. NAA'S POSITIONS ON THE ECR POUND RATE, THE LETTER/FLAT RATE DIFFERENTIAL, AND THE DENSITY-RELATED RATE DIFFERENTIALS ARE INCONSISTENT AND IGNORE THE INHERENT INTERRELATIONSHIPS BETWEEN THESE RATE ELEMENTS; IF ANY CHANGES ARE TO BE MADE TO THE PROPOSED RATES, THE LETTER/FLAT RATE DIFFERENTIAL SHOULD BE REDUCED.**

**A. In The Context Of The Postal Service's Overall Rate Design, Its Proposed Letter/Flat Rate Differentials, While High, Are Reasonable.**

In our initial brief, we pointed out that the Postal Service's proposal to maintain a letter/flat rate differential of 1.0¢ for high density mail and 0.7¢ for saturation mail represents high 80% and 60% passthroughs of the Postal Service's estimated cost differences. Moreover, because those cost differences represent *average* differentials between total letters and flats -- reflecting the cost effects of not just shape but weight -- the actual passthroughs of pure *shape-related* cost differences are even higher than those assumed by the Postal Service, as USPS witness Moeller acknowledged. Tr. 3138-40. This proposed letter/flat rate differential in combination with the proposed pound rate substantially over-recover the combined cost effects of shape and weight. Tr. 18316-18 (Crowder), Tr. 15171-72 (Haldi).

We would also note that Moeller's proposed rate differentials were originally based on a 35% passthrough of cost differences he obtained from witness Daniel. However, Daniel's cost differences were subsequently revised downward due to overstatements in flat costs. This cost revision is what elevated the passthroughs to 80% for saturation flats and 60% for high-density flats. USPS-T-36 at 47-48 (revised 10/3/97). Had Moeller been aware of the true cost differentials at the time he designed his rates, it seems likely he would have proposed lower letter/flat rate differentials, particularly given the fact that the cost differentials overstate the effect of shape alone.

**B. NAA Ignores The Inherent Interrelationship Between The Pound Rate And The Letter/Flat Rate Differential.**

NAA, predictably, takes the strident and irrational position that the Commission "should passthrough the cost differences between letters and flats at the ECR high-density and saturation tiers to the maximum extent possible, moving towards a full 100 [percent] passthrough of the cost differences between letters and flats." NAA Br. at 41. This position, particularly coupled with its position that the ECR pound rate should remain at its current excessive level and that the proposed ECR density-related discounts should be substantially reduced, is outrageous, irresponsible, and wholly unsupportable except as a device of a competitor to eliminate competition.

First, NAA conveniently overlooks the inherent interrelationship between the letter/flat discount and the pound rate. Even Val-Pak witness Haldi, who in Docket MC95-1 took a similar position advocating for a larger letter/flat rate differential and a high pound rate, now recognizes the inconsistency of that position. Haldi even demonstrates that under the Postal Service's proposal, the lower pound rate alone more than covers the entire letter/flat cost differential -- a result he finds "already hard to swallow" -- and that "in light of these considerations, I consider witness Moeller's recommended pound rate conservative." Tr. 15171-72. NAA, by contrast, plows ahead with its inconsistent "hit 'em twice" position, hoping for a pound rate that continues to grossly overcharge flat mailers for weight-related costs while praying for a flat surcharge that doubles the punishment.

Second, the mailing industry supports these Postal Service rate design proposals. This consensus among mailers is the best indication that the proposals are sound and make sense. The only opposition comes from competitors whose single-minded objective is to jack up rate levels and contrive a rate design using any arguments they can dream up , no matter how frivolous -- without regard to anything but

their own selfish interest as competitors -- in order to drive low-cost price-sensitive competitive mail out of the postal system and into theirs.

C. **If Density-Related Discounts Were To Be Reduced, Then The Letter/Flat Rate Differential Must Also Be Reduced Correspondingly.**

The underlying motive for NAA's position on maximizing the ECR letter/flat rate differential becomes starkly apparent in conjunction with its proposal to reduce the proposed ECR density-related presort discounts. NAA's attack on the proposed density presort discounts, ironically, is focused primarily at the discounts for high-density and saturation *letters*, not flats. Its real target, however, is saturation *flat* mailers like the Saturation Mail Coalition's members who compete most directly with newspapers.

This is where the letter/flat rate differential comes into play in NAA's strategy. If it were to succeed in reducing the saturation letter density discount, that would raise the saturation letter rate. Then, by freezing or even increasing the saturation letter/flat rate differential, its gambit would automatically raise the saturation *flat* rate by an equal or greater amount -- based on the reduction in the saturation *letter* density discount.

This kind of selective tinkering with the rate structure, changing one rate element in isolation without regard to its effect on other rates and the overall rate structure (or in NAA's case, with keen regard to its effects) ignores the sound ratemaking objective of achieving a balanced rate structure.

If the saturation letter discount were to be reduced, as NAA argues, then clearly the saturation letter/flat differential should be correspondingly reduced or eliminated to avoid penalizing saturation flat mailers with a punitive rate increase on account of saturation letter costing issues. The USPS proposed letter/flat rate differentials (0.7¢ for saturation flats and 1.0¢ for high-density flats) are, in fact, quite high if not truly excessive for a number of reasons:

- First, they reflect actual passthroughs of letter/flat cost differences (as revised) that are far greater than the Postal Service's originally intended passthroughs;

- Second, because the letter/flat cost differences include the effects of not just shape but weight, the true passthrough of *shape-related* costs (which are the only legitimate costs that should be recovered through a shape-based surcharge) are actually higher than the Postal Service's revised passthroughs and may even exceed the true shape-cost difference; and
- Third, shape-related costs differences would, in any event, be more than fully recovered through the Postal Service's proposed pound rate, which substantially exceeds weight-related costs.

Finally, such a corresponding reduction in the letter/flat rate differential, in addition to being justifiable for the above reasons on cost grounds, would also be essential as a matter of sound rate policy to reflect the high price sensitivity of saturation flat mail and to avoid rate shock to this important and highly competitive segment of the mail stream.

## V. ATTRIBUTABLE COST ISSUES.

### A. The Single Subclass Stop Method Cannot Be Applied Either To Coverage-Related Load Costs Or To Attribute Multiple Subclass Stops Between Subclasses.

Coverage Related Load Time. Joint Parties' witness Crowder, in response to an NAA interrogatory, explained why the single subclass stop methodology cannot be applied to attribution of coverage-related load time. Tr. 16233-42. She explained that coverage-related load costs cannot be directly traced to individual subclasses, except through a marginal analysis. Stop or access costs are fixed with respect to the amount of volume on a covered stop. However, coverage-related load costs are not fixed with respect to the amount of volume on the stop and represent more than just fixed load time costs. Because of scale economies, coverage-related load cost includes variable load cost. Since coverage-related load cost is measured at the average stop volume, the variable cost reflects the average stop volume. Variable cost associated with average stop volume is greater than the variable cost for a single subclass stop, and

should therefore not be attributed under a single subclass approach. Tr. 16234-16238, 16240.

On brief, NAA asks that the Commission simply ignore this record evidence. Its argument, in its entirety, is that:

“This argument was not in [Crowder’s] testimony. Her answer is quite complex and, on this record, has not received sufficient analysis to justify a departure from the Commission’s precedent.” NAA Br. at 44 n. 44.

What NAA doesn’t mention is that Crowder was responding to an interrogatory from NAA itself (NAA/JP-NOI3-1). NAA was apparently expecting a different answer than the one it got. NAA took its chances and lost, and now wants to pretend like it never happened.

NAA’s arguments are wholly without merit. Its quibble that Crowder’s response was “not in her testimony” is irrelevant. Her response, initiated by NAA’s own interrogatory, is in the evidentiary record. NAA’s lament that her response is “quite complex” overlooks that the problems identified by Crowder are straightforward, and she has clearly explained them. This feigned complexity surely is not a reason to disregard her response.<sup>17</sup> NAA’s claim that her response “has not received sufficient analysis” is particularly ironic. NAA had the opportunity but chose not to question Crowder about any of her load time testimony, and it chose not to file rebuttal testimony. Confronted with an answer it didn’t like and didn’t know how to rebut, NAA sat on its hands so it could argue on brief that (because of its own deliberate inaction) there has not been “sufficient analysis” of Crowder’s response. NAA’s recommendation to attribute coverage-related load time under the single subclass stop approach, like its request to ignore this evidence, should be rejected.

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<sup>17</sup> Had it gotten an answer it liked, we doubt NAA would be urging the Commission to ignore the response because of “complexity.”

Attribution of Multiple Subclass Stops to the ECR and Regular Subclasses. In a footnote on brief, NAA raises a new argument nowhere addressed on this record: that the Commission's single subclass stop concept should be expanded to allow attribution of multiple subclass stop costs to the ECR and Standard subclasses. NAA Br. at 42 n. 39. This argument must be rejected as a matter of law, and, in any event, is contrary to both the Commission's established method and the requirement that cost attributions be causally linked to a particularly subclass.

As a matter of law, consideration of this new issue -- which was not presented on the record and for which no evidentiary basis exists -- would violate the due process rights of the parties and the "hearing on the record" requirement of Section 3624(a) of the Act, 39 U.S.C. §3624(a). *Mail Order Association of America v. United States Postal Service*, 2 F.3d 408, 427-30 (D.C. Cir. 1993). As the court held,

"A review of the record makes clear that the Commission's novel access cost methodology was never subjected to scrutiny during the hearing, as required under the Act and, by incorporation, sections 556 and 557 of the APA." 2 F.2d at 429.

NAA, of course, is well aware of this judicial precedent which involved the same subject -- attribution of access costs -- as its non-record proposal here. By failing to raise this issue on the record, thereby preventing it from being "subjected to scrutiny during the hearing," NAA has forfeited any claim that the issue can properly be considered by the Commission in this proceeding.

In addition to this legal flaw, NAA's proposal is also contrary to (1) the Commission's established single subclass stop method, and (2) the requirement that cost attributions be causally linked to a particularly subclass. As NAA knows, the Commission has previously determined that multiple subclass stops cannot be attributed due to the lack of a sufficient causal link to a particular subclass. PRC Op. on Remand R90-1, at 55, ¶371. There is absolutely no evidence on this record, from NAA or anyone, to depart from that precedent.

NAA's proposal is also murky and internally inconsistent. It suggests that incremental costs should be measured "for Standard mail as a whole class," a grouping that includes eight subclasses,<sup>18</sup> and that these incremental costs should include "all multiple subclass stops at which only Standard mail is delivered." NAA Br. at 42. Although not stated, NAA apparently would have these "multiple subclass stops" allocated in some arbitrary fashion among the eight constituent Standard mail subclasses on the theory that they are "single *class* stops." This radical proposal to transform the "single subclass stop" concept into a "single *class* stop" concept is inconsistent with the Commission's approach. The "single *subclass* stop" methodology, in terminology and concept as well as in application, has been evaluated at the subclass level. As the Commission stated in its R90-1 remand decision, "Section 3622(b)(3) requires that all costs causally related to a *subclass* serve as the rate floor to which a judgmentally determined share of institutional costs are to be added." PRC R90-1 Op. on Remand at 54, ¶369 (emphasis added). There is no legitimate way to now attribute multiple subclass stops on the basis of a new, vague, internally inconsistent, and untested proposal presented on brief without evidentiary support on the record.<sup>19</sup>

**B. Witness Crowder's Analysis of City Delivery Carrier Load Time Costs Should Be Adopted.**

As the Postal Service points out, "both [USPS witness Baron and Joint Parties' witness Crowder] offer evidence which demonstrates the over-attribution which would occur should the Commission continue to use the established method" for

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<sup>18</sup> As a result of reclassification, the "Standard Class" now consists of separate subclasses for (1) Standard A Regular, (2) Standard A ECR, (3) Standard A Nonprofit Regular, (4) Standard A Nonprofit ECR, (5) Standard B Parcel Post, (6) Standard B Bound Printed Matter, (7) Standard B Special Rate, and (8) Standard B Library.

<sup>19</sup> This is not the first time NAA has attempted to introduce a new proposal for the first time on brief. See, e.g., *Direct Marketing Association v. United States Postal Service*, 778 F.2d 97, 107 (2nd Cir. 1985), where the court rejected a similar effort by NAA's predecessor, ANPA: "ANPA's arguments were made for the first time in a brief to the PRC, and were not based on record evidence."

attributing city delivery carrier load time costs. USPS Br. at III-154. Although their methods differ, their conclusion that the current method substantially overstates attributable load time is inescapable on this record.

The Postal Service acknowledges that Crowder has identified a serious mismatch problem between the STS estimate of load time and the LTV modeled load time. However, claiming that Crowder's approach "has not been adequately explored" on this record, the Postal Service urges that Baron's approach be adopted as a "conservative first step in this direction" pending further investigation of the issues raised by Crowder. *Id.* at III-156, 154. The three "unresolved issues" that the Postal Service cites concerning Crowder's approach (USPS Br. at III-150) are, in fact, fully addressed and resolved on the record:

- Baron's criticism that Crowder's model was mathematically "invalid" because her model load time "does not equal" true load time was shown on cross-examination to be specious. He conceded that, mathematically, her model *overstates* true load time and is therefore conservative. Tr. 17778-83; Joint Parties Initial Brief at 8-9.
- Baron's claimed "ambiguities" and "inconsistencies" in Crowder's treatment of the excess of STS costs over LTV costs were shown, instead, to stem from his own misinterpretations and mischaracterizations. Tr. 17784-90, 18435-36; Joint Parties Initial Brief at 9-11.
- Baron's specter that Crowder's approach would "mandate" abandonment of STS for apportioning street time among functions is nonsense. All that her approach implies is that the excess STS time includes a mix of non-elemental load time and stop-related access time, which in either case is treated as "coverage-related" cost. It does not in any way undermine the STS combined estimate of load-plus-access time or otherwise implicate the use of STS for other street activities. Joint Parties Initial Brief at 11.

In sum, Crowder's approach has been fully aired on the record. Her concepts, explanations, and models have been shown to be well supported and correct. Her mathematical model and attribution results, showing a substantial over-attribution of load time costs under the current methodology, have been shown to be conservative -- overstating true load time and under-correcting for the errors in the current approach.

There is nothing "incomplete" in her demonstration that requires further investigation. The Postal Service has not raised any legitimate reason to defer consideration of her approach, and it should be adopted by the Commission.<sup>20</sup>

### CONCLUSION

For the above reasons, the Saturation Mail Coalition urges the Commission to recommend to the Governors adoption of the classifications and rates proposed by the Postal Service in this proceeding.

Respectfully submitted,



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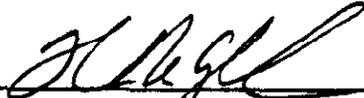
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<sup>20</sup> On the separate issue of Baron's incorrect application of a "deliveries effect" factor on multiple delivery stops -- unrelated to the above broader overattribution of load time -- the arguments in the Postal Service's initial brief are fully anticipated and answered in the Joint Parties Initial Brief, at 11-14. Baron's approach should be rejected for the reasons set forth therein and in Crowder's testimony, Tr. 16188-89, 16217-21.

CERTIFICATE OF SERVICE

I hereby certify that I have on this date served the foregoing document upon all participants of record in this proceeding in accordance with section 12 of the Rules of Practice.

  
Thomas W. McLaughlin

April 10, 1998